BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The opinion of the Tax Court (R. 15-25) is reported in 46 B. T. A. 821. The opinion of the Circuit Court of Appeals for the Eighth Circuit is reported in 137 F. (2d) 481.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 31, 1943. An order was filed by this Court on November 4, 1943, extending the time for filing a petition for a writ of certiorari until and including January 29, 1944. Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED, STATUTES INVOLVED, ETC.

A statement of the questions presented, specification of errors, a statement of the case, and the statutes and regulations involved are set out in the petition.

ARGUMENT

The Statutory Phrase "Amounts Which Can Be Distributed" Does Not Include the Taxpayer's Own Capital Stock.

First. The purpose of a contract prohibiting payment of dividends is to provide security for creditors or others holding obligations prior to the claims of shareholders. The creditor of a corporation is not normally concerned with whether his debtor distributes shares of its capital stock,

for any claims thereby accruing are subordinate to his own, and hence share-distributions are usually not prohibited in such contracts.

For this reason an interpretation of the statutory phrase as including share-distributions leaves little if anything upon which the statute can operate, and violates the oft-reiterated rule that, where another interpretation is reasonably permissible, a statute should not so be construed as to deprive it of all practical utility and leave it a nullity.

Second. In the *Dakota* case (p. 26) it was assumed that the court was called upon to construe the word "dividends". This is error; the critical word is "amounts", and this refers to earnings and profits.

"Amounts of earnings and profits" is the phraseology used in subdivision (2) of Section 26 (c), which is *in pari materia* with subdivision (1), the provision here in issue, since, as their common title "Contracts Restricting Payment of Dividends" indicates, the two "deal with precisely the same subject matter" (*United States* v. *Stewart*, 311 U. S. 60, 64), namely, the allowance of credit by reason of restrictive contracts. "Earnings and profits" in subdivision (2) can be represented only by the corporate debtor's property; it is only that, not the power to declare stock dividends, which can discharge indebtedness. Similarly, "amounts" in subdivision (1) can be represented only by the corporate debtor's property; for earnings are retained for the security of creditors, not by failure to declare stock dividends, but only when the corporation's property is not distributed.

Third. Legislative history supports the construction urged by the petitioner. As originally proposed, Section 26 (c) (1) provided for a credit only if there was "no form in which dividends" could be paid. H. R. 12395, Section 15 (a), 74th Cong., 2nd Sess. It was changed to its present lan-

guage on the floor of the Senate. 80 Cong. Rec. 9071. In explaining the change, Senator LaFollette, one of the Conference Managers on the part of the Senate, said that the new provision was "a much broader and more liberal one" than that originally proposed. 80 Cong. Rec. 10470. The only possible liberalization of any substantial consequence was to remove the condition that credit was allowable only if there was "no form" in which dividends could be paid.

Furthermore, in explaining one of the amendments of Section 26 made by Section 501 (a) of the Revenue Act of 1942, the Senate Committee on Finance explained in its report that the purpose was to afford relief to certain corporate taxpayers which did not have "sufficient assets" to make distributions permitting escape from the surtax on undistributed profits. S. Rep. 1631, 77th Cong., 2nd Sess., p. 245.

Fourth. The reason assigned by the Tax Court for denying a credit under Section 26 (c) (1) in this cause was (R. 23-24) that if a credit for dividends-paid is obtainable under Section 27 (e) of the Revenue Act of 1936 with respect to a taxable stock dividend, it is "apparent therefore" that no credit is allowable under Section 26 (c) (1). This reason would not of course support a denial of credit where, as here, the taxpayer had no unissued authorized stock, or where, as in the *Dakota* and *Kaufmann* cases, the taxpayer had only one authorized class of stock, and hence could not obtain a dividends-paid credit. However, that it is unsound in any event is demonstrated by the fact that, were it sound, it would apply with equal force where credit is claimed under subdivision (2). Yet its inapplicability where subdivision (2) is in issue is manifest, and it was so held in *G. B. R. Oil Corporation* v. *Commissioner*, 40 B. T. A. 738.

Fifth. The reason advanced in the *Kaufmann* case for adoption of the rule of the *Dakota* case is (p. 669) that

where the taxpayer has only one class of authorized stock or all authorized stock is issued, the prohibition is one imposed by the corporate charter and not by the contract and hence falls under the condemnation of *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46.

This is specious reasoning. Where a contract prohibits the payment of all dividends except stock dividends, both the prohibition and the exception are contractual. One looks outside the contract only to find the limits or meaning of the exception, and where share-distributions are excepted from the operation of the contract, it is to be presumed that the parties intended to except only such share-distributions as the corporation is otherwise legally authorized to make. The permissive grant is to be read as extending only to what may be done lawfully, not as extending to what the law does not allow.

The court below in answer to this argument said (p. 484) that "the corporation was at liberty to amend its charter if necessary to authorize" more stock. This is plain error: a corporation may not amend its charter; only the shareholders may do that.[4]

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[4]The court prefaced the quoted words with the qualifying phrase "so far as this record goes". Both the Circuit Court below (**Merchants' Exch. Bank** v. **McGraw**, 59 Fed. 972, 977) and the Tax Court (**Tonawanda Power Co.** v. **Commissioner**, 3 B. T. A. 1195, 1199) have held that the doctrine of judicial notice supplies such evidence as may be necessary to establish what a corporation may or may not do under the laws of the state of its incorporation. Moreover, the controlling Washington statutes were set out in the respondent's brief before the Circuit Court below, and they showed that only the shareholders could amend the charter.

The Contract Did Not Permit the Payment of Dividends in the Taxpayer's Own Obligations.

As has already been pointed out, the Tax Court's decision was silent as to whether dividends in the taxpayer's own obligations were within the prohibition of the contract. We think it fair nevertheless to say that the Tax Court may be regarded as having concluded that such dividends were within the prohibition and that, had it deemed an express finding necessary, the finding would have been to that effect. We make this statement for two reasons. The first is that, with respect to the Commissioner's argument (R. 23) that "the contract did not bar the payment of dividends in forms other than cash", the Tax Court mentioned only stock dividends as being outside the prohibition. The second reason is that it had refused to accept similar arguments in previous cases; in the *Paraport* case, for example, it had made the following answer to such a contention (p. 111):

> This contention, so far as it relates to the payment of dividends in bonds, requires but little discussion. The payment of dividends in bonds * * * would have effectively dissipated the security provided for the benefit of the lessor and would have been a plain attempt at evasion of the prohibitory provision of the contract.

We think it clear as a matter of law that the bank-creditor could under the terms of the contract have enjoined distribution of the taxpayer's obligations to its shareholders. Any other view would manifestly permit the taxpayer to destroy the security the contract was intended to provide. It is no answer to say, as did the Circuit Court of Appeals (137 F. (2d) 481, 484), that the obligations could be "in the form of bonds or long-term obligations": in the first place, if the taxpaper had the right to distribute its own obligations, it had also the right to fix their terms; second, even if long-term obligations were distributed, bankruptcy might intervene be-

fore maturity and the shareholders would then as creditors be entitled to pro rata participation with the bank; third, the indebtedness to the bank was represented by a running account without fixed maturity, and even long-term obligations might mature while the bank was still unpaid.[5] This last consideration makes inapplicable the decision of the Circuit Court of Appeals for the Second Circuit in *Commissioner* v. *Oswego Falls Corporation* (C. C. A. 2d), 137 F. (2d) 173 (reversing on another ground the Tax Court's decision in *Oswego Falls Corporation* v. *Commissioner, supra*), inasmuch as there the debt had a fixed maturity and the court held that bonds could have been distributed calling for payment at a later date. However, the *Oswego* appellate decision is unsound in any event, for the first two reasons assigned above.[6]

Respectfully submitted,

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[5]The Circuit Court of Appeals did not say what "long-term" obligations are. In the business world they are generally understood as obligations maturing after more than one year. See Paton, Accountants' Handbook, 3d ed., pp. 883-884.

[6]The Circuit Court of Appeals below tried to override the legal effect of the contract by saying (137 F. (2d) 481, 484) that the bank's officer testified that the bank "wanted to make sure that undue amounts of cash would not be disbursed", the court's intended implication being that the bank was not concerned about obligation-distributions. Of course the bank's rights under the contract could not be impaired by the officer's testimony as to what the bank's motive was. Furthermore, the court's statement is untrue; in the same breath the officer said (R. 48) that the bank was in like manner concerned that no notes be issued.

Had the contract been ambiguous, then its practical interpretation by the parties was important (**Topliff** v. **Topliff**, 122 U. S. 121, and **Brooklyn Life Ins. Co.** v. **Dutcher**, 95 U. S. 269) and the appellate court should have sent the case back to the trial tribunal for a finding based on the evidence as to interpretation.